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Audit Report Number 2009-PH-1008

TO: Vance T. Morris, Director, Office of Single Family Asset Management, HUF

FROM:  John P. Buck, Regional Inspector General for Audit, Philadelphia Region, 3AGA

SUBJECT: The City of Reading, Pennsylvania, Generally Administered Its Asset Control Area Program in Compliance with HUD Requirements

HIGHLIGHTS

What We Audited and Why

We audited the City of Reading's (City) asset control area program as part of a nationwide audit of the U.S. Department of Housing and Urban Development's (HUD) monitoring of program participants. Our objective was to determine whether the City administered its asset control area program in compliance with HUD requirements. We focused our review on whether the City complied with specific requirements in its asset control area agreement (agreement) with HUD pertaining to repairs for its acquired properties, resale of the properties, asset control area boundaries, and conflicts of interest.

What We Found

The City generally administered its asset control area program in compliance with HUD requirements by complying with specific requirements in its agreement with HUD pertaining to repairs for its acquired properties, resale of the properties, asset control area boundaries, and conflicts of interest.

Auditee's Response

We discussed the audit results with the City throughout the audit and at an exit conference on May 12 2009. The City provided written comments to our draft report on May 14, 2009. The City agreed with the audit report.

The complete text of the City's response can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVE

Section 204 of the National Housing Act (12 U.S.C. (*United States Code*) 1710) directs the U.S. Department of Housing and Urban Development (HUD) to promote the revitalization of neighborhoods through the creation of asset control areas in HUD-approved communities. HUD sells HUD-owned properties to authorized entities located within the asset control area at a discounted price. In turn, the authorized entities must ensure that the properties are rehabilitated or repaired and sold to eligible home buyers, officers, or teachers.

On November 17, 2005, HUD entered into an asset control area agreement (agreement) with the City of Reading (City) and Our City Reading, Inc. (OCR), a nonprofit organization. The City partnered with OCR to administer its asset control area program. OCR's function was to purchase asset control area properties from HUD, rehabilitate them and then market and sell them to eligible buyers. The City and OCR are collectively referred to as the City. Our review involved the third phase of the City's asset control area program. The third phase of the program was governed by the third asset control area agreement between HUD and the City. This agreement was entered into on November 17, 2005, and covered a period of 24 months. Under the agreement, the City acquired 59 properties from HUD at a cumulative discount of more than \$1.3 million. The City was required to manage the rehabilitation of the properties as necessary and sell them to eligible low- and moderate-income buyers, officers, or teachers at prices not to exceed the lesser of fair market value or 115 percent of eligible expenses to rehabilitate the properties.

Our objective was to determine whether the City administered its asset control area program in compliance with HUD requirements. We specifically focused on whether the City complied with specific requirements in its agreement with HUD pertaining to repairs for its acquired properties, resale of the properties, asset control area boundaries, and conflicts of interest.

RESULTS OF AUDIT

The City Generally Administered Its Asset Control Area Program in Compliance with HUD Requirements

The City complied with specific requirements in its agreement with HUD pertaining to repairs for its acquired properties, resale of the properties, asset control area boundaries, and conflicts of interest and, thereby, administered its asset control area program to increase homeownership for low- and moderate-income buyers and contribute to the revitalization of blighted communities.

The City Generally Repaired Its Asset Control Area Properties as Required

According to section 3.1 of the agreement, the City must perform all identified needed repairs before selling or leasing properties to eligible home buyers. The city prepares repair reports for each property before the properties are purchased from HUD. Also minimum property requirements or standards are identified and documented by the lender's appraiser. We performed inspections on a sample of 10 of the City's asset control area properties to verify that the needed repairs had been completed. The City had completed all needed repairs on nine of the properties. For the remaining property, we found a basement door that the City was scheduled to replace but had not. The City missed the incomplete repair when it reviewed its subcontractor's work to verify that all scheduled repairs had been completed. Once we identified the incomplete repair, the City's project manager for its asset control area properties took immediate action and contacted the subcontractor during our site visit to request that the door be replaced. The City later provided evidence to show that the door had been replaced.

Although the City generally repaired its asset control area properties as needed, it did not review HUD's minimum repair requirements attached to the appraisal reports provided when it purchased the properties from HUD. Appendix D, Valuation Protocol, in HUD Handbook 4150.2, Valuation Analysis for Single Family One- to Four- Unit Dwellings, requires appraisers to note the repairs necessary to make a property comply with the Federal Housing Administration's (FHA) minimum property requirements (MPR) or standards, together with the estimated repair cost. The MPR repairs are attached to the property's appraisal report as a supplemental addendum, which states that the property did not meet the minimum FHA property standards. The addendum also lists the MPR repairs and the estimated cost of the repair. The MPR repairs are only required when a home buyer finances the home purchase with an FHA loan. However, it would be

a prudent practice for the City to review and incorporate the MPR repairs in its list of scheduled repairs so that its properties comply with FHA requirements in the event that an eligible home buyer qualifies for and elects to purchase a home with an FHA loan. We reconciled the MPR repair requirements with the City's completed repair reports for the 10 properties inspected and did not note any outstanding required repairs. We recommended that the City change its practice and begin to review HUD's minimum repair requirements. The City established and provided us a copy of the policy.

Based on our observations during the site visits to the City's asset control area properties, we concluded that its asset control area program had a positive impact on its neighborhoods. In one of the neighborhoods, the City had rehabilitated five homes over the course of the three phases of its asset control area program. This neighborhood appeared to be quiet and well maintained by all of the homeowners. We also observed that a non-asset-control-area homeowner had remodeled the exterior of his property similar to that of an adjoining asset control area property.

The City Generally Complied with Resale Requirements

The agreement between the City and HUD included resale provisions which required the City to ensure that home buyers were eligible and provide them prepurchase counseling, sell its acquired properties at the lesser of fair market value or 115 percent of the net development costs,¹ sell the properties within 18 months of acquiring them, and ensure home buyers' compliance with occupancy requirements. The City generally complied with these requirements.

The City Ensured That Home Buyers Were Eligible and Provided Prepurchase Counseling to Home Buyers

The agreement defines eligible buyers as individuals who have income at or below 115 percent of the local area median income adjusted for family size, as defined by HUD, for the fiscal year in which the City is selling the property. Section 5.2D of the agreement requires the City to provide prepurchase housing counseling to all eligible buyers through a HUD-approved counseling agency. For a non-representative sample of four properties, we verified that the home buyers were within the defined income limits by comparing their reported income to corresponding verification of employment requests. We also verified that the income levels were within the limits set by HUD for calendar years 2006 and 2007. In addition, we verified that the home buyers received prepurchase counseling.

¹ The net development cost represents the total cost to purchase and repair the property less ineligible costs (identified in exhibit 8 of the asset control area agreement).

The City Priced and Sold Its Properties in Accordance with Asset Control Area Program Requirements

According to section 5.3A of the agreement, the City must sell its acquired properties at the lesser of fair market value/appraised value or 115 percent of the net development cost. Section 5.3B states that all eligible expenses must be substantiated with copies of paid invoices or receipts and copies of reports generated by the City that include all required information on an individual property basis. The City appropriately priced all 59 properties it acquired at fair market value, which was lower than 115 percent of the net development cost for each property. The City also maintained job ledger reports for each property to show eligible expenses and sources of funding. We verified that the City correctly based its property sale prices on fair market value by comparing the fair market values of all of the properties with the corresponding net development costs multiplied by 115 percent. We also verified that expenses included in net development costs for a sample of nine properties were eligible. In addition, we verified that expenses for four of the nine properties were supported by appropriate documentation.

The City Rehabilitated Its Acquired Properties but Was Unable to Sell All of Them within the Required Timeframe

According to section 5.4 of the agreement, the City must sell the asset control area properties within 18 months of the transfer date. The City requested the demolition of one property and sold 48 of the 59 properties it acquired in phase III of the agreement. Of the 10 properties remaining in the City's inventory, eight had been transferred to the City more than 18 months earlier. Therefore, the City did not meet the requirement to sell these properties within 18 months of the transfer date. All 10 of the City's properties had been repaired and were available for sale. The City stated that some of the causes for not selling all of its properties within the required timeframe included the sluggish economy and the fact that the properties were in a high crime neighborhood. The City was making efforts to sell its outstanding properties. City staff stated that "for sale" signs initially had to be removed because they advertised that the homes were vacant, causing them to become targets of crime. However, starting in November of 2008, the City installed and activated home alarm systems on the properties and had put the "for sale" signs back on the properties. The City also made use of mass mailing and provided us a copy of a mass mailer it sent out to renters in the area. The mass mailer included basic information on the City's asset control area program pertaining to the number of homes available for sale, upgrades to the homes, general qualification requirements, and the general range of expected monthly payments for the homes. The City should continue to make bona fide efforts to sell its outstanding properties.

The City Required and Monitored Home Buyers' Compliance with Occupancy Requirements

Based on requirements in section 5.5C of the agreement, an eligible buyer must occupy a purchased property for at least three years (one year if an officer or a teacher). To ensure that this requirement is met, the City places a stipulation in the property deed indicating the minimum time the home buyer must occupy the property. The City stated that it had not been contacted by any title companies regarding properties resold in violation of the occupancy requirements. City staff performed public record searches for 43 of the properties sold in phase III of the City's agreement and provided evidence from the county tax assessor's office to show that none of the City's sold phase III asset control area properties had been resold by the home buyers. Also, we performed public record searches on home buyers for five selected properties and did not note any issues.

The City Complied with Conflict-of-Interest Provisions

Section 2.3A of the agreement dealing with conflicts of interest states, "Purchaser and their agents, board of directors, principal staff and contractors shall avoid any all conflicts of interest and self-dealing." Section 2.3B further states, "Purchaser shall not employ staff who also work for and receive a financial benefit from any entity that is providing the Purchaser with services related to the asset control area Program." We performed research on employees from the City, its local partner OCR, OCR's board of directors, and Neighborhood Housing Service (a partnering entity of OCR) and found no conflicts of interest between the City and its related entities. We also researched the business of OCR and noticed that Boscov's Department Stores (Boscov's) was listed as a business associate. The City purchased appliances and other items for its asset control area properties from Boscov's. However, OCR obtained a waiver from HUD, which allowed it to use Boscov's for goods and services as long as the goods or services were at cost. During our review to determine whether expenses charged for the City's asset control area properties were supported, we verified that Boscov's items were sold to the City at cost.

Properties Transferred to the City Were Located within the Asset Control Area Boundaries

According to section 2.2 of the agreement, the City's asset control area consists of the geographic areas identified in exhibit 1 of the agreement. HUD sends notices to the City when an asset control area property in the Reading, Pennsylvania, geographic areas is available for purchase. Also, the agreement states that HUD

will provide the City written notice in the event that any geographic area no longer meets the eligibility criteria for revitalization areas. We verified the census blocks of the City's phase III properties to the areas identified in exhibit 1 of the agreement. We also selected a random sample of 10 properties and verified that they were located within approved asset control areas.

Conclusion

The City generally administered its asset control area program in compliance with HUD requirements by complying with specific requirements in its agreement with HUD pertaining to repairs for its acquired properties, resale of the properties, asset control area boundaries, and conflicts of interest and, thereby, administered the program to increase homeownership for low- and moderate-income borrowers and contribute to the revitalization of blighted communities.

SCOPE AND METHODOLOGY

We performed the audit at the office of the City's local partner, OCR, located at 2561 Bernville Road, Reading, Pennsylvania. Our review covered the period January 1, 2006, through December 31, 2007, but was expanded as necessary to achieve our audit objective. We focused on the third phase of the City's asset control area program which started November 17, 2005, and covered a period of 24 months.

As of November 2008, HUD had not formally issued asset control area regulations. Therefore, in conducting our review, we mainly followed HUD's standard operating procedures for the asset control area program and the asset control area agreement between HUD and the City.

During the audit, we assessed the reliability of computer-processed data relevant to our audit by comparing the data to hard-copy information. We found the computer-processed data sufficiently reliable to meet our audit objectives.

To accomplish our audit objectives, we obtained and reviewed the following:

- The asset control area agreement and documents related to the City's asset control area application.
- Independent accountants' reports on the City's asset control area program.
- Correspondence prepared by HUD, the City, and other related parties.
- Information obtained from public records using data retrieval tools including LexisNexis.
- HUD reviews of the City including e-mails and memorandums.
- Documentation on the City's asset control area properties including but not limited to supporting documentation for net development costs, home buyer eligibility, and property sales.
- Audited financial statements for OCR for the period ending December 31, 2007.

We also performed the following:

We reviewed relevant documents for the 59 properties the City acquired to determine whether the properties were rehabilitated and sold within the timeframe specified by the asset control area agreement. For all 59 of the City's acquired asset control area properties, we compared the actual or estimated resale prices with appraisal reports and information on net development costs to determine the basis of the resale price. In all 59 cases, the City based the resale price on fair market value. In addition, we randomly selected and reviewed files for nine properties to determine whether net development costs for the properties were based on eligible expenses. For four of the nine properties, we also ensured that the expenses were supported by tracing them to the appropriate supporting documentation.

We reviewed files pertaining to a random sample of four sold properties to determine whether the home buyers met the eligibility requirements stipulated by the asset control area agreement.

We randomly selected and inspected five each of properties sold and properties available for sale to verify that required/needed repairs had been completed.

We performed public record searches on home buyers of the first five properties on the City's November 5, 2008, listing of asset control area properties and related addresses to determine whether they complied with the occupancy requirements of the asset control area program.

We researched 10 properties through HUD's Utility Automation Integrators system to determine whether they were located in asset control areas.

In addition, we held discussions with staff from the City, OCR, and HUD's Philadelphia Real Estate Owned division.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following controls are achieved:

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objectives:

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.
- Validity and reliability of data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

We did not identify any significant weaknesses in the relevant controls identified above.

APPENDIX

Appendix A

AUDITEE COMMENTS




May 14, 2009

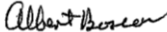
Dear Mr. Buck,

This is to inform you that the City of Reading and Our City of Reading, as partners in the local ACA contract of the Reading area, have reviewed the audit report and concur with the report results.

Once again, we would like to thank you for all of your help in this audit, and we will implement the recommendations outlined by both Jim Carrington, and the report in our future ACA program.

Sincerely,


Ryan Hottenstein
Managing Director
City of Reading


Albert Boscov
Chairman
Our City Reading